

ECONOMIC FREEDOM AS PRECONDITION FOR ECONOMIC PROSPERITY: CROATIAN EXPERIENCE

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ABSTRACT

The purpose of this paper is to give a brief theoretical overview of the notion of economic freedom and discuss it as being a link between economic opportunity and prosperity. First part of the paper offers definition of the economic freedom, (basic) arguments for the limited role of the state in the national economy as well as it discusses one of indexes - Heritage Foundation Index - used worldwide for measuring economic freedom. Based upon the theoretical overview and presented index, the second part of the paper will evaluate economic freedom in the Republic of Croatia and suggest some policy implication how to redefine the role of the state in order to make it more supportive for market's needs.

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1. INTRODUCTION

From classics of economic thought such as Adam Smith (1776-1937) or David Ricardo (1821-1912) up to modern scholars, theoretical and empirical economic literature has been emphasizing the link between economic prosperity with the whole range of elements united in the concept of «economic freedom». The most succinct definition of economic freedom could be simply following: economic freedom is the right of individual to follow his/her own interests through voluntary exchange of property rights which are ensured to him/her through the rule of law. In other words, individuals are free to work, produce, consume and invest in a way they want to and the state must not limit that freedom but to protect it. Empiri-

cal studies, as well as world economic statistics, show that countries with higher degree of economic freedom have higher rates of economic growth and tend to be more prosperous (e.g. Gordillo & Alvarez, 2003). Also, countries which are more economically free have more political and civil freedoms which speaks in favor of Nobel laureate Milton Friedman's view that economic freedom is a precondition of political freedom (Friedman, 1962).

The purpose of this paper is to give a brief theoretical overview of the notion of economic freedom and discuss it as being a link between economic opportunity and prosperity. First part of the paper offers definition of the economic freedom, (basic) arguments for the limited role of the state in the national economy as well as it discusses one of indexes - Index of Economic Freedom by the Heritage Foundation - used worldwide for measuring economic freedom. Based upon the theoretical overview and presented index, the second part of the paper will evaluate economic freedom in the Republic of Croatia and suggest some policy implication how to re-define the role of the state in order to make it more supportive for market's needs.

2. ECONOMIC FREEDOM AS A LINK BETWEEN ECONOMIC OPPORTUNITY AND ECONOMIC PROSPERITY

2.1. What is economic freedom?

There are numerous definitions of the economic freedom. For example, economic freedom represents: freedom from regulation or other dictates from government or other authority in economic (business) matters (source: All Business Glossary, D&B Company); freedom to produce, trade and consume any goods and services acquired without the use of force, fraud or theft. This is embodied in the rule of law, property rights and freedom of contract, and characterized by external and internal openness of the markets, the protection of property rights and freedom of economic initiative (source: Wikipedia); the right of individuals and organizations to pursue their own interests through voluntary exchange of goods and services under the rule of law (source: The American Heritage of Dictionary of Business Terms). The central elements of economic freedom are "personal choice, freedom of exchange, and protection of private property" (Gwartney & Lawson, 1997: 2). If economic freedom is constitutionally guaranteed and protected, individuals are more able to make private choices regarding which goods and services to consume, which economic activities to engage in, and how to use their resources, including their time.

Economic freedom¹ is often identified with notions of political and civil liberty. However, there is a distinction between these notions. Political liberty is related to the process of political decision-making, i.e. whether citizens are allowed/free to participate in a political process on an equal basis or not. Civil liberty, on the other hand, includes varieties of rights such as right of expression, practicing various religions, free assembly, fair trials, etc. In his book *“Capitalism and Freedom”* Milton Friedman (1962: 7-17) argued that economic and political freedom are deeply and complexly intervened in a way that economic freedom is a mean to the end of the political freedom, i.e. economic freedom is a necessary condition for political freedom.² Contemporary research also supports this argument. For example, a study by de Haan and Sturm titled *“Does more Democracy Lead to Greater Economic Freedom? New Evidence for Developing Countries”* shows that an increase in economic freedom between 1975 and 1990 has been associated with the level of political freedom (see more de Haan, 2003).

2.2. How to measure economic freedom?

Economic freedom is a concept that is not easy to measure because it involves both quality and quantity (de Haan, 2003: 395). The most common way of evaluating economic freedom is by using an *index of economic freedom* which represents a cumulative indicator calculated based upon greater number of chosen variables which are aggregated as pondered average values in sub-indexes and then gathered in the main index. There are three most known indexes that measure economic freedom across the world: (i) *Economic Freedom of the World Index* (EFW); (ii) *Index of Economic Freedom by Heritage Foundation* and (iii) *Freedom House Index*. All these indexes try to make a link between the meaning of the economic freedom and analytical framework of contemporary economics, but at the same time they take different emphasis and approaches in explaining, i.e. evaluating economic liberty (Kešeljević, 2007). For example, *Index of Freedom by Heritage Foundation* is focused

¹ One can find the notion of economic liberty instead of economic freedom. Baletić & Budak (2007: 807) describe a fine line between these two terms. The term freedom is associated with the *sense of freedom* in the sociological-psychological way while the term liberty refers to *guaranteed freedom* by the law in the institutional-legal sense. They use Ludwig von Mises's argument that “liberty is always freedom of the government” meaning that the freedom guaranteed by the market economy is not only the economic freedom but it is related to the morality, spirituality and intellect.

² Opposite to this argument, Jeremy Bentham, John Mill and Philosophical Radicals considered political freedom as a means to economic freedom. See more on Bentham's and Mill's liberalism in Levi (2007).

mostly on the regulatory framework of the country while the *Economic Freedom of the World Index* is related mostly to the macroeconomic performance, i.e. macroeconomic indicators.

In this paper we briefly present the *Index of Economic Freedom* which was developed jointly by the think tank Heritage Foundation and Wall Street Journal in 1995. This index measures ten components of economic freedom, assigning a grade in each using a scale from 0 to 100, where 100 represents the maximum freedom and the rest as follows: 0-49.9 repressive economy; 50-59.9 mostly unfree; 60-69.9 moderately free; 70-79.9 mostly free and 80-100 free. The ten component scores are then averaged to give an overall economic freedom score for each country. According to the Heritage Foundation, there are 10 components of economic freedom³:

1. **Business freedom** is a quantitative measure of the ability to start, operate, and close a business that represents the overall burden of regulation as well as the efficiency of government in the regulatory process.
2. **Trade freedom** is a composite measure of the absence of tariff and non-tariff barriers that affect imports and exports of goods and services.
3. **Fiscal freedom** is a measure of the tax burden imposed by government. It includes both the direct tax burden in terms of the top tax rates on individual and corporate incomes and the overall amount of tax revenue as a percentage of GDP.
4. **Government spending:** This component considers the level of government expenditures as a percentage of GDP. Government expenditures, including consumption and transfers, account for the entire score.
5. **Monetary freedom** combines a measure of price stability with an assessment of price controls. Both inflation and price controls distort market activity. Price stability without microeconomic intervention is the ideal state for the free market.
6. **Investment freedom,** In an economically free country, there would be no constraints on the flow of investment capital. Individuals and firms would be allowed to move their resources into and out of specific activities both internally and across the country's borders without restriction.

³ For more detailed description of each component (e.g. factors used for scoring each component, numerical variables, formulas, data sources, etc.) see Hertage Organization: 2010 Index of Economic Freedom, available at <http://www.heritage.org/index/> (17.03.2010.)

- 7. Financial freedom** is a measure of banking security as well as a measure of independence from government control. State ownership of banks and other financial institutions such as insurers and capital markets reduces competition and generally lowers the level of available services.
- 8. Property freedom:** The property rights component is an assessment of the ability of individuals to accumulate private property, secured by clear laws that are fully enforced by the state. It measures the degree to which a country's laws protect private property rights and the degree to which its government enforces those laws. It also assesses the likelihood that private property will be expropriated and analyzes the independence of the judiciary, the existence of corruption within the judiciary, and the ability of individuals and businesses to enforce contracts. The more certain the legal protection of property, the higher a country's score; similarly, the greater the chances of government expropriation of property, the lower a country's score. Countries that fall between two categories may receive an intermediate score.
- 9. Freedom from corruption:** Corruption erodes economic freedom by introducing insecurity and uncertainty into economic relationships. The score for this component is derived primarily from Transparency International's Corruption Perceptions Index (CPI) for 2008, which measures the level of corruption in 180 countries.
- 10. Labor freedom:** The labor freedom component is a quantitative measure that looks into various aspects of the legal and regulatory framework of a country's labor market. It provides cross-country data on regulations concerning minimum wages; laws inhibiting layoffs; severance requirements; and measurable regulatory burdens on hiring, hours, and so on.

The Index of Economic Freedom by Heritage Foundation (hereinafter: Heritage Index of Economic Freedom) has become rather popular measure of progress in market reforms across the world and it has been often 'consulted' by investors since it gives useful information about business environment, stability and arrangement of the country's regulatory system.

2.3. Why is economic freedom important?

Various studies have analyzed the relationship between economic growth and economic freedom (e.g. Carlsson & Lundström, 2002; Pitlik, 2002; Heckelman & Stroup, 2000; Dawson, 1998). Judging by the number of empirical research, one

can conclude that economic freedom is associated with many benefits. For example, Gwartney and Lawson (1997) found out that lower level of economic freedom led to lower unemployment; Grubel (1998) demonstrated positive impact of the economic freedom on welfare indicators such as life expectancy, income distribution and unemployment; Lawson (2008) interestingly pointed out that that low-income people in freer countries were better off than their counterparts in less-free countries; Norton (1998) showed a positive correlation between economic freedom and the environment, etc. Thus, economic freedom is related to wide ranging array of desirable economic and social outcomes.

There are some critics of the measurement of economic freedom. For example, Jim Stanford and the late Margaret Legum strongly condemn the measurements of economic freedom published by the Fraser Institute and the Heritage Foundation.⁴ They have argued that the economic freedom is not the only thing that matters. As Hall (2008) pointed out they indicated correctly that there were other things that people find important besides economic freedom. Namely, “countries with higher degrees of economic freedom are given higher scores, but it did not follow directly that these countries were somehow better. Whether one should prefer more or less economic freedom is indeed a normative judgment. However, for those who make their normative judgments on consequentiality grounds, the existence of this measurement makes it possible to test long-standing claims, and counterclaims, that economic freedom enhances prosperity and other social goals” (Hall, 2008: 261). Still, the critics of the measurement of economic freedom have hard time arguing against indexes of economic freedom since the body of empirical evidence related to the link between economic freedom and desirable social outcomes has been growing in recent years.

3. CROATIAN ECONOMIC FREEDOM: CHALLENGES AND PERSPECTIVE

3.1. Macroeconomic profile of Croatia

Croatia is a small open economy with the population of 4.4 million people (Census, 2001), has relatively high educated labor force, gross domestic product (GDP) per capita of 10,682 EUR and the gross domestic product (GDP) structure similar to other industrial market economy. After declaring its independence

⁴ For more details on their work see more in Stanford (2007) and Legum (2007) as well as a comment on their work by Hall et al. (2008).

in June 1991, it entered the process of transition aiming to achieve market economy and political democracy. The comprehensive political and economic reforms of the country were additionally lumbered by the Homeland War from 1991 to 1995 which caused serious damages of infrastructure and a decline in the country's economic vitality. Almost two decades later, Croatia has managed to restore its macroeconomic stability and made significant advances in the structural reforms that have led the country closer to its goal of developing fully-fledged market economy and becoming a member of the EU.

Table 1 Selected economic indicators for Croatia (2004 – 2008)

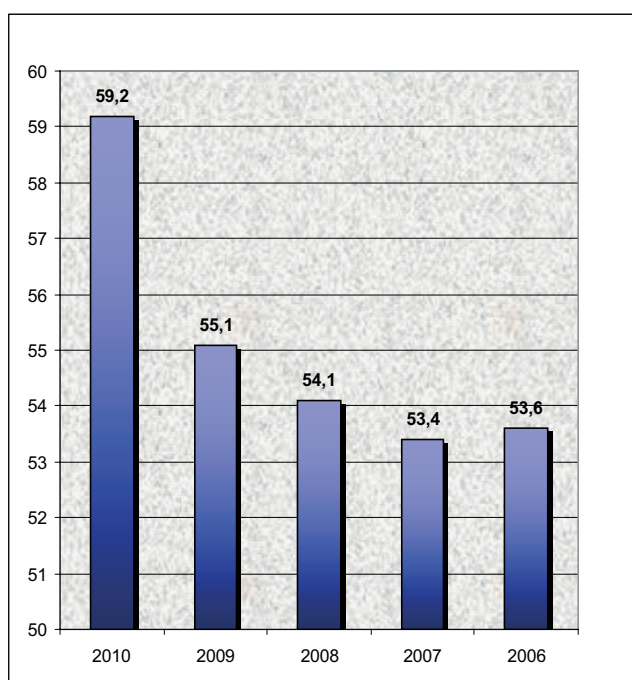
Economic indicators	2004	2005	2006	2007	2008
GDP per capita, current prices (in EUR)	7.380	8.043	8.807	9.656	10.682
GDP, constant prices, annual % change	4.2	4.2	4.7	5.5	2.4
Inflation, annual % change	2.1	3.3	3.2	2.9	6.1
Unemployment (according to ILO)	13.8	12.7	11.2	9.6	8.4
Current account balance in % of GDP	-1.434	-1.976	-2.717	-3.238	-4.369
External debt in % of GDP	70.0	72.1	74.9	76.9	82.6
Public Debt, as % of GDP	37.9	38.5	36.0	33.4	29.3
FDI (in million EUR)	1.467,9	2.764,8	3.670,2	4.190,2	1.699,2

Source: Croatian National Bank (2010)

3.2. Croatian performance by the Heritage Index of Economic Freedom

Croatia has been included in the Index of Economic Freedom by Heritage Foundation since 1996. For the last five years Croatia has been graded as the *mostly un-free economy* by Heritage Index of Economic Freedom (figure 1). The score of 59.2 in 2010 is the best so far, making Croatian economy the 92nd freest in the 2010 *Index*.⁵ Its overall score is 4.1 points higher than last year, reflecting significantly improved scores for government spending, investment freedom, and protection of property rights. Croatia has moved up 24 places in the world rankings and from 38th to 37th out of 43 countries in the Europe region. However, its overall score is still below the regional and world averages.

⁵ The top ten countries according to the 2010 Index of Freedom are following: Hong Kong (89.7), Singapore (86.1), Australia (82.6), New Zealand (82.1), Ireland (81.3), Switzerland (81.1), Canada (80.4), USA (78.0), Denmark (77.9) and Chile (77.2). Source of data: Heritage Organization, <http://www.heritage.org/index/> (17.03.2010.)

Figure 1 Croatian overall index of economic freedom 2006-2010

Source: Heritage Foundation (2010)

If components of the Index of Economic Freedom are observed for the period between 2006 and 2010 (table 2), it can be noticed that Croatia has been scored *mostly free and free* in the areas of trade, fiscal and monetary freedom; *moderately free* in the areas of investment, doing business and finances; and mostly *unfree and repressed* in the area of property rights, corruption, government spending and labor market.⁶

Trade freedom continues to be the best graded area of economic freedom in Croatia. It would be fully free area if there were no additional custom duties, import licensing for certain goods, burdensome regulations and standards, inefficient customs administration, and weak enforcement of intellectual property rights add to the cost of trade. Points deducted from the full freedom score account for non-tariff barriers. As far as fiscal freedom is concerned, Croatia has a high income tax rate but a low corporate tax rate. The top income tax rate is 45 percent, and the top corporate tax rate is 20 %. There is also a value-added tax (VAT). In the most recent year, overall tax revenue as a percentage of GDP was 23.4 %. High scores

⁶ Following interpretation of scores mostly relies on reports by Heritage Organization that can be obtained at the official website of the Heritage Foundation, www.heritage.com (Accessed 17.03.2010.)

in monetary freedom have been attributed to the moderate inflation rate that has been oscillating at the level of 5% in recent years. Even though the majority of price supports and subsidies have been removed, the price control remains for some 30 products, mostly basic (food) provisions that require approval by the Ministry of Economy, Labor and Entrepreneurship, as well as through influence on prices 'dictated' by the state-owned enterprises.

Investment policy in Croatia treats foreign investors as national one. Despite all the reforms conducted, inefficient bureaucracy remains a problem, as well as corruption. Croatian efforts to become a full member of the European Union (EU) represent a motivation to increase transparency as well as to adopt EU laws, norms and practices. Croatian Constitution guarantees the free transfer and repatriation of profits and invested capital for foreign investments while some capital transactions are subjected to government conditions (e.g. inward portfolio investments). If a foreign investor want to acquire property, he/she need an approval by the Ministry of Justice, excluding the case when the property is acquired by inheritance or reciprocity. Financial system in Croatia is rather competitive and efficient, but the bank system is almost fully in foreign hands (e.g. two national commercial banks are majority foreign-owned and control almost half of all assets, and foreign banks own the majority of total assets). Supervisory and regulatory frameworks for the financial sector are more efficient, credit is allocated on market terms, and access to finances for entrepreneurs is not difficult. The stock exchange has been growing and currently more than 200 companies are listed while securities markets are open to foreign investors. Also, the Capital Market Act came into force in 2009 with the aim to secure effective regulation and transparency. Croatian regulatory environment has been rather burdensome and often cited by the business community as one of the greatest impediment for doing business, followed by the corruption and inadequate sources of finances. Namely, the Croatian regulatory framework is encumbered by the red tape, out-of-dated and unnecessary law provisions, and the like, all of which increase the cost of doing business, create barriers to investments, as well as it represents a serious source of corruption. Starting business in Croatia takes 22 days which is lower than the world average of 35 days, but on the other hand, getting business licenses takes longer than 218 days which is world average. Closing a business is relatively simple.

Restrictions in property rights, government spending, freedom from corruption and labor freedom remain Croatian Achilles' hill. Namely, property rights are burdened by the inefficiency of judiciary system and non-transparency of public

administration (e.g. long duration of court proceedings, lack of specialized employees in administration and judiciary system, out-of-date files in cadastres and land records, etc.). Despite intellectual property rights legislation, piracy of digital media and counterfeiting continue. According to data of the Croatian Central Bank (CCB), the total government expenditures (including consumption and transfer payments) are relatively high, amounting to 49% of GDP while the government's total debt is oscillating at the level of 35 of GDP in recent years. Corruption in Croatia is still perceived as significant. According to the Transparency International (2009), Croatia is ranked 66th out of 180 countries with the Corruption Perceptions Index (CPI) of 4.1. The judicial system is seen as most affected by corruption. Labor freedom in Croatia is significantly restricted. The employment protection legislation in Croatia is among the most rigid in Europe. Termination is difficult and costly while the non-salary cost of employing a worker is high. Flexible forms of employment are quite limited. All of stated discourages employers to create new work places.

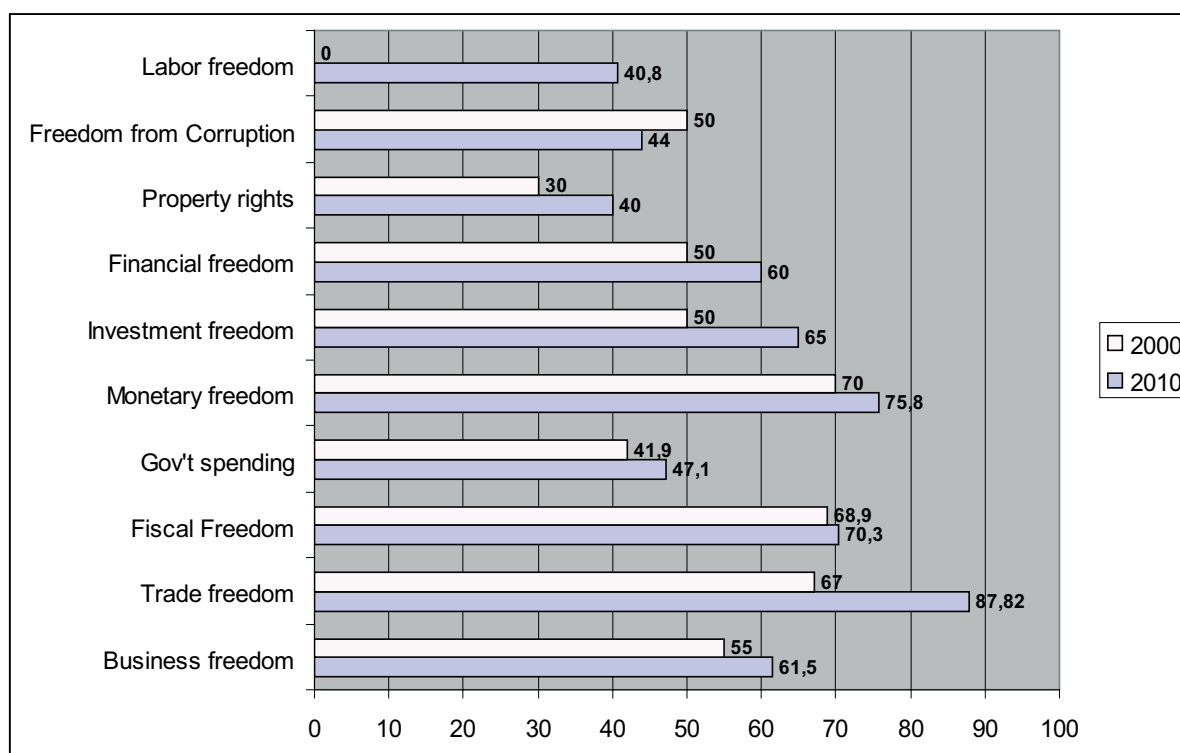
Table 2 Components of Index of Economic Freedom of Croatia (2006 – 2010)

Year	Business freedom	Trade freedom	Fiscal Freedom	Gov't spending	Monetary freedom	Investment freedom	Financial freedom	Property rights	Freedom from Corruption	Labor freedom
2010	61,5	87,82	70,3	47,1	75,8	65	60	40	44	40,8
2009	59,9	87,6	68,7	31,7	79	50	60	30	41	43,4
2008	58,5	87,6	68,8	28	78,8	50	60	30	34	45,5
2007	54,2	87,8	69,9	24,4	79,3	50	60	30	34	44,5
2006	54,5	78,4	69,6	23,2	81,2	50	70	30	35	44,6
2000	55	67	68,9	41,9	70	50	50	30	50	-

Note: Labor freedom component was introduced in 2005.

Source: Heritage Foundation (2010)

If one observes the period of last ten years, it can be noticed that improvements in individual components of economic freedom have been made as suggested by table 3.

Table 3 Ten Economic Freedoms of Croatia compared, 2000 and 2010

Source: Heritage Foundation (2010)

The most positive change has been made in the area of trade freedom, followed by the business freedom and investment freedom. Unfortunately, the most negative change happened in respect to the freedom of corruption whereby the index dropped by 10 points in the period from 2000 to 2010. This comparison serves well to show that the problems related to the issues such as property rights or government spending are deeply rooted and need (immediate) attention if Croatia wants to move up on the rang list of economically free countries, which by theory implies more economic prosperity.

4. CONCLUDING REMARKS: POLICY SUGGESTIONS

If Croatia wants to improve the rank on the list of most economically free countries of the world, it needs to adopt the changes in the role of government in the national economy. Ensuring greater economic freedom of Croatia calls for rethinking the role of the state in order to be more supportive of the market needs.

Namely, the role of the state in the national economy is multifold: it holds the executive power and engages in the interaction with the private sector and other agents in the society; it is a legislator and fundamental warrantor of legal framework

and legal safety in which the private sector operates; at the same time, the state influences the way civil and entrepreneurial rights are respected through its equity and transparency. Thus, the greatest responsibility of the Croatian government is to focus on its efficiency-enhancing role in the national economy, i.e. to provide qualitative institutional and legislative framework that ensures sustainable growth and development as well as to lessen its own entrepreneurial activity. In another words, the government needs to support *market-based institutions*, i.e. rules, enforcement mechanisms and organizations supporting market transactions in order to transmit information efficiently, to enforce property rights and contracts and to secure competition which will in turn affect incentives to participate in a market.

Taking into considerations the Heritage Index of Economic Freedom for Croatia, overall and by individual components, advancing economic freedom of Croatia calls for following: (i) to ensure more professional and efficient public administration which protects public interests of citizens while at the same time work on reducing the costs of its operations; (ii) to increase the professional competences and knowledge of all employed in public administration as well as to increase the transparency of public administration work; reduce red tape and bureaucracy which will in turn reduce the sources of corruption; (iii) to develop the just, efficient and competent judiciary system which work will be harmonized with the EU law and practice; (iv) to lessen the entrepreneurial role of the state and focus its work on correcting market failures; (v) introduce the flat rate on income, profit and VAT; (vi) to ensure enforcement of property rights; (vi) to facilitate flexicurity on labor market, i.e. to relax the labor regulations in a way to promote flexibility to employers to adjust to fluctuations and changes in society, economy or production on one side, but to make certain that workers' social security is not jeopardized; (vii) to ensure deregulation of business in order to make it easier for new firms to enter markets, which increases competition and hence resource efficiency; (viii) to lessen the burden of taxes and contributions; (ix) to adequately determine a size of government's expenditures in accordance with their efficiency; (x) to implement fiscal decentralization.⁷

⁷ The Adriatic Institute for Public Policy (AIPP) provides numerous suggestions how to improve economic freedom of Croatia. The AIPP is an independent free market think tank founded in 2004 in Srdoci, Rijeka, Croatia and dedicated to strengthening the rule of law and advancing economic freedom through advocating market reforms in Croatia and southeast Europe. More details can be obtained on the official web site of the AIPP, <http://adriaticinstitute.org>

As already mentioned, the Heritage Index of Economic Freedom, as well as other indexes, is often cited in the business literature and it is increasingly popular measure of progress in market reforms. However, it has been taken with certain attentiveness for it can be misleading in certain cases. For example, the index may be lower in countries in which economic relations are well determined (Baletić & Budak, 2007: 817). Also, many authors point out that indexes of economic freedom cannot be sufficient indicators of future prosperity because of following problems: (i) subjectivity problem and institutional shortcomings; (ii) problem of non-consistent division; (iii) problem of choice and (iv) problem of aggregation.⁸ Still, (problematic) issues that such indexes point out - as it is case for Croatia when the Heritage Index of Economic Freedom is considered - should be taken into consideration by policy makers for they can be very instructive of prescribed but balanced role of government in fostering economic freedom through its institutional and legislative framework.

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